DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0264
Gross Income Tax, Adjusted Gross Income Tax, and Penalty
For the Years 2001-2002

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ISSUES

I. Gross Income Tax—Applicability

Authority: IC § 6-2.1-1-2; IC § 6-2.1-1-11; IC § 6-2.1-2-2; IC § 6-2.1-4-6; I.R.C. § 78; *F.W. Woolworth Co. v. Taxation & Revenue Dept. of New Mexico,* 458 U.S. 354 (1982); *Indiana Dep't of State Revenue v. Sohio Petroleum Co.,* 170 Ind. App. 123, 352 N.E.2d 95 (Ind. Ct. App. 1976).

Taxpayer protests the assessment of gross income tax with respect to dividends from affiliated companies and with respect to a dividend "gross-up."

II. Adjusted Gross Income Tax—Dividends

Authority: 26 CFR 1.1502-13

Taxpayer protests the recomputation of Taxpayer's adjusted gross income with respect to certain dividends.

III. Tax Administration—Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a negligence penalty.

STATEMENT OF FACTS

Taxpayer is a company domiciled in Indiana. Taxpayer has eleven affiliated companies ("Affiliates"). Taxpayer filed a consolidated gross income tax return with Affiliates and filed a consolidated adjusted gross income tax return with three of the affiliated companies. Taxpayer also owned a foreign sales company ("FSC").

During the years in question, Taxpayer received dividends from Affiliates and FSC. In addition, Taxpayer included a dividend "gross-up" required under I.R.C. § 78 on Taxpayer's federal

income tax return. Taxpayer excluded the dividends that it received from Affiliates and FSC, as well as the dividend "gross-up," from its gross income subject to Indiana gross income tax. In addition, Taxpayer excluded these same dividends from its adjusted gross income.

The Department audited Taxpayer's returns for the years in question and determined that the dividends from Affiliates and FSC previously excluded by Taxpayer should be included in Taxpayer's gross income. In addition, the Department determined that the dividend "gross-up" required under I.R.C. § 78 was includible in Taxpayer's gross income.

Further, the Department determined that the dividends the Taxpayer received from Affiliates should have been included in Taxpayer's adjusted gross income. Based on these adjustments, the Department assessed additional tax, interest, and penalty. Taxpayer protested the assessment, the Department conducted a hearing, and this Letter of Findings results.

I. Gross Income Tax—Applicability

DISCUSSION

A. AFFILIATED COMPANIES

Taxpayer's first point of contention is with respect to the inclusion of dividends that it received from Affiliates. In particular, Taxpayer argues that, since Affiliates are included in Taxpayer's consolidated gross income tax return, the dividends are deductible as intragroup transfers.

Under IC § 6-2.1-2-2(a)(1) (repealed 2003),

> An income tax, known as the gross income tax, is imposed upon the receipt of:
> (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana.

However, IC § 6-2.1-4-6 states in relevant part:

> (a) Except as provided in subsections (b) and (c), each taxable year an affiliated group of corporations filing a consolidated return pursuant to IC 6-2.1-5-5 is entitled to a deduction from the gross income reported on such a return. The amount of the deduction equals the total amount of gross income received during the taxable year from transactions between members of the group that are incorporated or authorized to do business in Indiana.
> (b) The deduction provided by this section does not apply to gross income received by a member of an affiliated group and derived from sources outside Indiana.

Thus, the dividends paid from Affiliates to Taxpayer were part of Taxpayer's gross income under IC § 6-2.1-2-2. The issue becomes whether Taxpayer is entitled to a deduction for these dividends.

As IC § 6-2.1-4-6 states, Taxpayer is eligible for a deduction of income "from transactions between members of the group that are incorporated or authorized to do business in Indiana." However, the deduction only applies if the gross income is received by Affiliates from Indiana sources. In other words, the section prevents the same receipt from being counted twice in an affiliated group's returns.

With respect to this argument, Taxpayer has provided sufficient legal grounds to conclude that the dividends *may* be subject to elimination under IC § 6-2.1-4-6. However, the deduction is predicated on the second prong of the elimination statute; the initial receipts by Affiliates must have been included in Affiliates' gross income subject to Indiana gross income tax. The amount of gross receipts derived by Affiliates from Indiana sources is subject to audit verification.

B. FOREIGN SERVICE COMPANY

Taxpayer's second point of contention is with respect to dividends received by FSC. In particular, Taxpayer argues that the dividends reflect income earned by FSC outside Indiana, and therefore are not subject to Indiana gross income tax.

Taxpayer cites to IC § 6-2.1-1-2(c)(6), which states that

> The term "gross income" does not include
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> . . .
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> (6) gross receipts received by corporations incorporated under the laws of Indiana from a trade or business situated and regularly carried on at a legal situs outside Indiana or from activities incident to such trade or business (including the disposal of capital assets or other properties which were acquired and used in such trade or business)

Taxpayer further cites to *Indiana Dep't of State Revenue v. Sohio Petroleum Co.*, 170 Ind. App. 123, 352 N.E.2d 95 (Ind. Ct. App. 1976) for the proposition that the dividends from FSC are exempt. In *Sohio Petroleum*, Old Ben Coal Co. (Old Ben) owned the fifty percent of the stock of another company, Algers, Winslow and Western Railroad (AWW). Both Old Ben and AWW were Indiana Corporations.

Old Ben stored the AWW stock certificates in Illinois. AWW paid dividends to Old Ben. Old Ben did not report the dividends as gross receipts subject to gross income tax. The Department of Revenue assessed additional tax because one Indiana corporation (AWW) paid dividends to another Indiana corporation (Old Ben). The court agreed with the Department of Revenue's interpretation, and stated,

> It is the location of the corporation which pays dividends on stock held by an Indiana corporation at its out-of-state principal place of business that determines whether the dividends constitute taxable gross income to the recipient.

Id. at 132-133, 352 N.E.2d at 101.

Taxpayer's argument is that FSC conducted its entire business outside Indiana. Taxpayer contrasts FSC operations—conducted entirely outside Indiana—with AWW's incorporation and conduct of business in Indiana. Taxpayer argues that under *Sohio Petroleum*, AWW's location inside Indiana determined Old Ben's situs for dividends received from AWW; therefore, FSC's location outside Indiana should determine whether Taxpayer's dividends from FSC constitute gross income to Taxpayer.

However, the statute determines the exclusion of gross income by reference to the recipient's—Taxpayer's—activities conducted outside Indiana. In short, is *Taxpayer* conducting business outside Indiana? In this case, the income received by Taxpayer was a dividend rather than receipts from a business activity that Taxpayer carried out in another jurisdiction. Furthermore, the activities of FSC are not imputed to Taxpayer as might otherwise occur in the case of a partnership .

Unlike *Sohio Petroleum*, in which the court sought to prevent an absurd result of two Indiana corporations not being taxed on gross receipts between the two corporations, the taxation of Taxpayer's dividends from FSC do not result in an absurd result. The tax applied in this situation merely is the recognition that an intangible generally follows the situs of the intangible's owner, in this case Taxpayer.

C. I.R.C. § 78 DIVIDEND "GROSS UP"

Taxpayer's third point of contention is with respect to a dividend "gross-up." Under I.R.C. § 78, a taxpayer is required to add certain foreign taxes to its income. The addition is an amount of foreign taxes paid on a dividend if: 1. the taxpayer receives a dividend; and 2. claims a foreign tax credit based on the receipt of that dividend.

I.R.C. § 78 can best be described an example used in *F.W. Woolworth Co. v. Taxation & Revenue Dept. of New Mexico*, 458 U.S. 354, 358 n.6 (1982) (internal citations omitted).

> Woolworth gives this example: "If a foreign subsidiary of a United States parent earns $ 100, pays foreign tax of $ 40, and pays a dividend of $ 30 out of its after-tax profits of $ 60, the deemed paid foreign tax credit of the parent under section 902(a) is 30/60 x $ 40, or $ 20. The parent includes $ 50 in dividend income (*i. e.*, the actual dividend of $ 30 plus $ 20 of 'gross-up') and claims a foreign tax credit of $ 20 against the federal income tax on this income."

Under I.C. § 6-2.1-1-11,

> "Receives", as applied to a taxpayer, means:
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> (1) the actual coming into possession of, or the crediting to, the taxpayer, of gross income; or
> (2) the payment of a taxpayer's expenses, debts, or other

The dividend "gross-up" under I.R.C. § 78 reflects taxes paid by a foreign company, on behalf of the foreign company, to a foreign government. The "gross-up" is never received, either directly or indirectly, by Taxpayer. The "gross-up" is not money or property received by the domestic company—Taxpayer in this case—and thus is not taxable as gross income for Indiana gross income tax purposes.

FINDING

Taxpayer's protest is sustained subject to audit review with respect to the dividends from domestic affiliated companies. Taxpayer's protest is denied with respect to dividends from FSC. Taxpayer's protest is sustained with respect to the foreign dividend "gross-up."

II. Adjusted Gross Income Tax—Dividends

DISCUSSION

Taxpayer also protests the imposition of adjusted gross income tax with respect to its receipt of dividends from Affiliates. In particular, Taxpayer argues that it did not include the dividends from Affiliates in its "qualifying dividends" listed on its federal income tax return because it eliminated the dividends as an intercompany transfer. Thus, the dividend was never included in Taxpayer's federal taxable income, and the amount carried onto Taxpayer's Indiana return—based on Taxpayer's federal taxable income—did not include the dividends from Affiliates. Taxpayer cites to 26 CFR 1.1502-13(f)(2)(ii), which states:

> An intercompany distribution is not included in the gross income of the distributee member (B). However, this exclusion applies to a distribution only to the extent there is a corresponding negative adjustment reflected under § 1.1502-32 in B's basis in the stock of the distributing member (S). For example, no amount is included in B's gross income under section 301(c)(3) from a distribution in excess of the basis of the stock of a subsidiary that results in an excess loss account under § 1.1502-32(a) which is treated as negative basis under § 1.1502-19. B's dividend received deduction under section 243(a)(3) is determined without regard to any intercompany distributions under this paragraph (f)(2) to the extent they are not included in gross income. See § 1.1502-26(b) (applicability of the dividends received deduction to distributions not excluded from gross income, such as a distribution from the common parent to a subsidiary owning stock of the common parent).

Taxpayer's exclusion, rather than deduction, of the dividends from Affiliates was proper. Furthermore, the exclusion of dividends in this case was based on a non-circular flow of funds from related entities that may give rise to alternative allocation or apportionment of income.

FINDING

Taxpayer's protest is sustained.

III. Tax Administration—Penalty

DISCUSSION

Taxpayer argues that it is not subject to negligence penalties with respect to the additional taxes assessed. In particular, Taxpayer argues that the additional tax was due to its different, but reasonable, interpretation of the statute. Accordingly, Taxpayer argues that it was not negligent in preparing its tax returns and computing its tax liability for the years in question.

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1. The Indiana Administrative Code, 45 IAC 15-11-2, further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
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> (c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> > (1) the nature of the tax involved;
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> > (2) judicial precedents set by Indiana courts;
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> > (3) judicial precedents established in jurisdictions outside Indiana;
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> > (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
> >
> > (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer's returns and the positions taken with respect to those returns were the result of reasonable business care, and therefore penalty imposition is not warranted in this instance.

FINDING

Taxpayer's protest is sustained.

JR/BK/DK April 10, 2007